



In Defense of Europe's Grand Bargain

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Welcome to the hotel California... You can [try to] check-out any time you like, but you can never leave!

—Eagles, *Hotel California*

Nothing is easier than pointing fingers at policymakers working feverishly at 2 a.m. to contain a rapidly spreading financial crisis. Rarely has this been truer for the European Union than during the current crisis's amateurish policy management. Yet, what really matters is the final result, which is far more positive for Europe than the ugly sausage-making process.¹

In this policy brief I take the premise that the current European crisis is principally fiscal in nature and argue that

during the weekend of May 8–9, 2010 European leaders crafted a very important and constructive political “grand bargain” between EU member states and the European Central Bank (ECB) with far reaching, positive implications for the credibility of the European Union's fiscal policy framework and the long-term sustainability of European government finances. I further illustrate that if Greece is ultimately forced to default on its debts, it is certain the Greek government would want to do it within the eurozone.² As such, a Greek default poses no risk to the composition of the eurozone, which considering that a German departure is equally unlikely is a secure monetary union. I conclude with a set of required next steps for Europe.

EUROPE'S CRISIS MANAGEMENT

Preventing financial crises from spreading always requires decisive action from policymakers and a “big number” to completely dispel financial market's uncertainties about the political will to act. The reason for this is simple. To function, financial markets require something to disagree on. There must always be two sides to a trade, and for transactions to take place (and price volatility to emerge), buyers and sellers need to disagree on the price of an asset. However, in a financial crisis, invariably characterized by herd-like behavior by financial-market participants, everyone becomes convinced about the imminent financial collapse of companies, banks, or even countries. As such, policymakers need to put together “an overwhelming official response” to change the minds of a sufficiently large number of market participants to stabilize asset prices.

Unfortunately for Europe's ability to act in a financial crisis, EU institutions are, as a direct result of their unique regional supranational composition, extremely ill-suited to produce a “decisive response” to communicate to financial

1. This policy brief is based on postings by the author on the Peterson Institute RealTime Economics Issues Watch between March and May 2010, where they benefited greatly from the advice of Steve Weisman. RealTime is available at www.piie.com/realtime.

2. As laid out in Cline (2010) and Mussa (2010), a credible technical debt dynamic case can be made that under some scenarios Greece may not ultimately have to default on its debts. However, factoring in likely political pressures in both Greece and the eurozone, I do believe that a Greek default is the most probable long-term scenario.

markets. Consider the usual list of attendees at an ECOFIN Council meeting: finance ministers of 27 sovereign member states, three members of the European Commission, president of the ECB, president of the European Investment Bank, and the two chairmen of the European Commission's Economic Policy and Economic and Financial Committees.³ Each of the 27 member states will have their own legitimate national interests to defend at any EU "crisis solution summit," where the cost of ending the crisis will be distributed. Lastly, each of these meetings is overseen by the representative of the six-month rotating EU presidency,⁴ guaranteeing that no "institutional crisis management experience" is accumulated within EU institutions.

European leaders have produced a very constructive political "grand bargain" between the ECB and the EU (especially eurozone) member states concerning the future of European monetary union.

Simply put, there is no "US Treasury Secretary (or staff) at the end of the negotiating table" to take the final decision in Europe. Instead, any European decision to act in a crisis must by definition be a political compromise between large numbers of different actors. Meanwhile, given the participation of multiple sovereign governments, each with their individual democratic mandates to defend at meetings where the "bill is split among member states," the imposition of any degree of "message discipline" during a European crisis response process is both impossible and potentially politically illegitimate.

As a result, this European crisis management has been (and any future European crisis responses is doomed to likewise be) characterized by a plethora of often conflicting policy positions, leaks to the press, and public policy trial balloons carried out by the representatives of individual member states, the ECB, and other EU institutions.⁵ This might be good for

day-traders but inevitably leaves the impression of a paralyzed European Union unable to respond and might lead financial markets to the erroneous conclusion that Europe's crisis solutions lack credibility.

In this situation, it becomes crucial for outside observers and financial markets to largely ignore this messy EU policy-making process and the associated media chatter and instead focus on what is actually agreed among the EU members and institutions in the form of written compromises of the EU Council or eurozone communiqués.

Here, a different picture of European policymaking is clearly visible: certainly, a process filled with policy U-turns and reversals of previous positions but also one characterized by rapid learning, pragmatism, and genuine policy innovation.

Consider how all of Europe's numerous and often poorly timed policy reversals during this crisis between February and May 2010 have been in the "right direction." On February 11, 2010 European leaders started with their vague promises to "take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole" with no euro figures mentioned and no International Monetary Fund (IMF) involvement.⁶ Yet, on May 9, 2010, EU leaders concluded with a European Financial Stabilization Facility (EFSF) worth up to €750 billion (assuming an additional 50 percent IMF participation) "subject to strong conditionality...on terms and conditions similar to the IMF."⁷

In other words, in three months European leaders went from "no number and no IMF involvement" to the required "big number with 100 percent IMF conditionality" for all the money involved. Considering that this is the first "2 a.m. before the markets open moment" for European institutions since the launch of the euro in 1999 and the numerous institutional challenges for the European Union to produce an effective crisis response, this is a remarkable and very positive outcome of a messy process. It is furthermore difficult to imagine a stronger endorsement of existing multilateral financial organizations in the form of the IMF than the willingness of large eurozone governments to quite literally commit hundreds of billions of taxpayer's money to other eurozone members exclusively under IMF conditionality.

3. See, for instance, the attendee list for the May 18, 2010 ECOFIN Council meeting at www.consilium.europa.eu.

4. During the first half of 2010, the rotating presidency of the European Union has been with Spain, one of the EU member states most affected by the contagion from Greece.

5. The disastrous and amateurish unilateral German announcement of a "ban on naked shorts" on May 18, 2010 as part of the domestic German political process of securing parliamentary approval, Germany's national participation on the EU crisis response is probably the best example hereof. As part of the German parliamentary discussion, a "political link" was created between

participating in the €750 billion EU crisis response and punishing financial speculators. This led to the unilateral German ban, which has no chance of being effective as naked short-sellers will simply move out of Germany; appeared to split the European Union at a crucial point during the crisis management; and gave the impression that the German government was merely papering over the real underlying problem, namely the undercapitalization of the German (and eurozone) banking system and its related vulnerability to losses on Greek debt.

6. See EU Council Statement at www.consilium.europa.eu.

7. See ECOFIN Council Statement at www.consilium.europa.eu.

EUROPE'S "GRAND BARGAIN"

Of far larger long-term importance, European leaders have produced a very constructive political "grand bargain" between the ECB, on the one hand, and the EU (especially eurozone) member states, on the other, concerning the future of European monetary union.

To understand how the ECB can credibly negotiate far reaching "political deals" with its own sovereign owners among the EU member states,⁸ its uniquely independent institutional status must be recalled. Unlike the central bank of any individual nation, the ECB's independence is guaranteed by the European Union's governing Treaty,⁹ which no individual EU member state government can change on its own.

Contrasting further with say the US Federal Reserve or the Bank of England, both of which owe their current degree of independence to reversible decisions by their own national governments and parliaments, the ECB cannot be ordered to do anything against its will by any single EU political leader (or groups of EU leaders).¹⁰ Moreover, as this crisis has shown, the ECB Governing Council is willing to take controversial decisions without unanimity (in principle the ECB takes decisions through regular majorities on its Governing Council) indicating that the national representatives of any single eurozone member can at anytime be outvoted on the Governing Council. Consequently, it can credibly negotiate with EU member states as an independent actor and need only enter into bargains that a majority of its own Governing Council approves of.

8. In theory, the owners of the ECB are all 27 EU member states through their national central banks. Ownership is calculated using a key that, equally weighed, reflects the respective country's share in the total population and EU GDP. National shares are adjusted every five years and whenever a new country joins the European Union. Only the 16 eurozone members have "fully paid-up capital subscriptions" to the ECB and a seat on the ECB governing board. The European Union's 11 non-euro area member states' central banks must contribute to the operational costs incurred by the ECB in relation to their participation in the European System of Central Banks (ESCB) by providing a minimum percentage of their total subscribed capital. These contributions at the current eurozone and EU memberships represent 7 percent of non-eurozone members' total subscribed ECB capital, or about €120 million out of the ECB's total current fully paid-up capital of just over €4 billion. For details, see ECB, Capital Subscription, available at www.ecb.int.

9. Article 130 states clearly that "When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body" (*Official Journal of the European Union* 51, May 9, 2008, available at www.ecb.int/ecb/legal).

10. Article 127 lays out how the EU Council may, through a unanimous vote and after consultations with the European Parliament and the ECB itself "confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings."

For its part of Europe's grand bargain, the ECB during the night of May 9, 2010 agreed to move beyond its minimalist "we care only about price stability" Bundesbank legacy (and did so probably against the votes of the Germans on the Council) and instead agreed to become a credible "lender of last resort" and crisis manager for the entire eurozone by granting its own Governing Board the ability to buy at its volition essentially any asset—public or private—it wants through its new Securities Market Program (SMP).¹¹ In addition to this critical shift in its policy stance, the ECB previously on May 3 had also reversed itself by agreeing to accept as collateral in its credit operations securities issued or guaranteed by the Greek government, irrespective of the credit rating.¹²

With the new powers the ECB essentially granted itself and its demonstrated willingness to use them (the ECB has bought a total of €40.4 billion worth of securities through the SMP during the first four weeks¹³), the ECB now has the ability to counter the risk of a sudden freeze of European credit markets, similar to what occurred immediately following the collapse of Lehman Brothers in September 2008. As a result, the ECB is now in far better shape to address any immediate financial panic, following a likely Greek default or any other unforeseen adverse future financial event in the eurozone. It is important to keep in mind that the ECB has given itself a tool to effectively deal with economic crises—in its own words:

"The objective of this programme [the SMP] is to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism."¹⁴

As such, the ECB has never agreed to conduct a policy of quantitative easing (QE) in the eurozone. Consequently, recent

11. The ECB leadership on May 10 pledged to "conduct interventions in the euro area public and private debt securities markets (Securities Markets Program) to ensure depth and liquidity in those market segments that are dysfunctional. The objective of this program is to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism. The scope of the interventions will be determined by the Governing Council." The ECB pledged to sterilize these interventions and has to date done so via collecting one-week fixed-term deposits corresponding to the size of the SMP of €40.4 billion to date (June 11, 2010). For details, see ECB, Open Market Operations, available at www.ecb.int.

12. "ECB announces change in eligibility of debt instruments issued or guaranteed by the Greek government," press release, May 3, 2010, available at www.ecb.int. On May 10, the ECB further agreed to offer full allotments of its 3- and 6-month regular long-term refinancing operations, as well as in collaboration with the US Federal Reserve reactivate temporary liquidity swap lines aimed at providing US dollar liquidity.

13. The ECB publishes only the total sum of its weekly security purchases under the SMP, not the precise composition hereof or the counterparties. The ECB's weekly financial operations are available at www.ecb.int.

14. See ECB, Open Market Operations, available at www.ecb.int.

critique¹⁵ from financial markets that the ECB is gradually phasing out the SMP, since it has been gradually reducing its weekly SMP purchases (€16.3 billion in week 1, €10.4 billion in week 2, €8.8 billion in week 3, and €4.9 billion in week 4 [last week of available data]),¹⁶ is totally misguided (and potentially directly self-serving, as big financial-market participants have a clear incentive to try and sell their own risky, for instance, Greek debt to the ECB in the secondary market, thereby reducing their own exposure through a straightforward risk transfer from the private to the public sector).

Contrary to claims that the ECB has lost credibility via its frequent policy reversals, recent events represent a quantum leap forward in the ECB's ability to act as a Europe-wide financial crisis manager.

Crisis management tools do not equal sustained QE, as conducted by, for instance, the Bank of England and Federal Reserve, and if the ECB deems selected securities markets to be less dysfunctional at present, its Governing Council should reduce such purchases to zero soon. In doing so, it is acting precisely in accordance with its previously stated policy goals and in a manner that has no implications on its future freedom to intervene in financial markets in a crisis or on other aspects of the European crisis response.

Contrary to claims that the ECB has lost credibility via its frequent policy reversals, recent events represent a quantum leap forward in the ECB's ability to act as a Europe-wide financial crisis manager. It has in the process shown admirable flexibility and willingness to reverse itself when facts so demanded.

The crucial and politically more important question, however, is what the EU member states contributed to the European grand bargain. First, as described above, EU members and eurozone members in particular agreed among themselves to put up a total of €500 billion for the EFSE.¹⁷

The new EFSF consists of two parts. The first is an expansion of the existing European Commission balance of payments (BoP) facility for non-eurozone members by €60 billion in new money guaranteed through the EU budget by all 27 member states. Combined with the current uncommitted €35 billion

(out of a total of €50 billion) from the pre-existing BoP facility, which has now been made available to all EU member states, the European Union has an immediate total of €95 billion available to fight the financial crisis. Combined with a probable additional 50 percent contribution from the IMF to any intervention, the number is around €145 billion. That would be a sufficiently "big number" to deal in the short to medium term with even a Greece-like scenario in another small EU member state (e.g., Portugal, Ireland, or Belgium).

The other part of the EFSF consists of a €440 billion special purpose vehicle (SPV) consisting of pooled bilateral guarantees from the 16 eurozone countries. Due to the bilateral nature of the pooled guarantees, some "implementation risk" has surrounded this pledge. This has been displayed most prominently in Germany, which as the eurozone's largest economy and the European Union's traditional paymaster will shoulder the biggest potential burden of up to \$187 billion from this grand bargain.¹⁸

As such, the historical importance of the speedy May 21, 2010 approval by the German Parliament of this measure should not be underestimated or get lost in the regretful (but necessary for domestic German parliamentary tactical reasons) announcement of the unilateral attempt to outlaw "naked short" trading.¹⁹ In all but name, the larger SPV-part of the EFSF amounts to a "joint eurobond usable only in a crisis," which at such time provides weaker eurozone members access to financing through the fiscal credibility of stronger eurozone members. It is German acceptance of this fact that really matters.

Moreover, as the BoP facility is the "first line of defense" and deals with small members, the €440 billion SPV is best thought of as the "big member state eurozone crisis response mechanism." This matters tremendously for the political credibility of the SPV, as it would only be called upon if any of the large eurozone members, e.g., Spain or Italy, faced an imminent Greece-style descent into financial chaos. The

18. See Jacob F. Kirkegaard, "Europe Rises to the Occasion, but the World Shares the Cost," RealTime Economic Issues Watch, May 11, 2010, available at www.piiie.com/realtime, for details on how to estimate the combined contribution of Germany through the bilateral €440 billion SPV, €60 billion BoP facility, and the probable €250 billion IMF contribution. These estimates exclude the possible 20 percent additional German participation in the €440 billion SPV laid out in the final agreement; see footnote 20 for a detailed description.

19. See Alan Crawford, "Germany to Ban Naked Short-selling at Midnight," Bloomberg.com, May 18, 2010, available at www.bloomberg.com. It is important to note that while the main German opposition party, the SPD, abstained in the parliamentary vote, it did so not because it was opposed to Germany's participation in the EFSE. The SPD abstained because there was no specific link in the legislation to also tax private financial firms. See "Merkel Pushes Euro Rescue Deal Through Parliament," Spiegel Online International, May 21, 2010, available at www.spiegel.de.

15. See, for instance, "Doubts on ECB Bond Buying," *Financial Times*, June 8, 2010, 24.

16. See footnote 13 for source.

17. See ECOFIN Council Statement, available at <http://www.consilium.europa.eu>.

precise details of how the SPV becomes operational are less important.²⁰ Given that the sovereign default of either Spain or Italy would trigger a eurozone-wide if not global financial meltdown, the actual political risk that in a “2 a.m. crisis scenario” the SPV (with probable additional 50 percent IMF participation) would not be politically approved is effectively zero. Knowing the truly catastrophic—and far worse than in the case of Greece—alternative to approval, Europe’s politicians would, if ever asked, blink and authorize disbursements from the SPV (subject, as mentioned, to IMF conditionality).

The second part of EU member states’ contribution to the grand bargain, however, is far more important than the first.

If Greece is ultimately forced to default on its debts, it is certain the Greek government would want to do it within the eurozone.

Here it is immediately evident that European “fiscal union” and massive regular institutionalized intra-European fiscal transfers among the member states are not part of the deal. They are simply not possible for the reason that no revision of the EU Treaty (which would be required for this scenario to unfold) that makes such a fiscal union/institutionalized regular transfers a reality will ever be ratified by all the 27 EU member states or indeed even by the key eurozone members themselves.

Rather than a “fiscal union,” what member states have contributed to the grand bargain is a “fiscal straitjacket” and “legislated deflation,” as we have so far seen in Latvia, Ireland, Greece (too late of course), Spain, Portugal and (less so) Italy,²¹ where governments have cut public wages—wages in

Europe have proved far less sticky in this crisis than economic theory would predict—and taken a host of other fiscal austerity measures. The sheer number of new austerity measures announced in Europe since May 10 is indicative of the new-found political willingness of affected eurozone governments to finally address their long-standing fiscal issues, as well as move more aggressively on the equally important issue of fundamental structural reforms of labor markets, pension, and healthcare systems.

The volte face of the Spanish leftwing government—just days after the grand bargain was announced—to likely commit political suicide by cutting public wages and freezing pensions suggests that this new willingness to “take the austerity pain no matter the political costs” among eurozone governments should be taken far more seriously than before. What the world will get from Europe is coordinated fiscal austerity and essentially a move “back to Maastricht Treaty basics.” With deficits so severely restricted, Europe’s grand bargain will shift the continent decisively away from Keynesian economics. Moreover, as illustrated by the recent victory of the most fiscally austere party in the Dutch election in early June 2010 (the first national election in the European Union after the May 10 grand bargain), these fiscal policies have revealed public appeal in Europe.²²

Moreover, the recent announcement by the German government of additional austerity measures worth a total of €26.6 billion from 2011 to 2014 (about 1 percent of GDP),²³ intended to focus mostly on structural spending cuts to welfare payments and reduction in the public sector, clearly shows that new austerity measures in Europe will not just be concentrated among the weakest Southern eurozone member states. With anchor-country Germany clearly intent on “leading by example,” all other eurozone member states with long-term fiscal sustainability issues (including France and indeed most other eurozone members with the possible exception of Luxembourg, Finland, and Slovakia) will be under strong economic pressure to follow suit to avoid a further widening of long-term bond market spreads between say French and German 10-year bonds—at the time of writing, 50 basis points.²⁴ Such widening sovereign spreads, which are likely

20. The EFSF will function as a limited liability company (an SPV) under Luxembourg law (*Société Anonyme*) to collect funds and provide loans in conjunction with the IMF to cover the financing needs of euro area member states in difficulty. The shareholding of each member state in the EFSF will correspond to its respective share in the paid-up capital of the ECB, and the EFSF will become operational once a critical mass of member states, representing 90 percent of shareholding, has completed the relevant national parliamentary procedures. To improve the ultimate credit rating of the SPV, each member state will be liable for up to 120 percent of its prorata share to avoid low-rated individual eurozone members dragging down the credit rating in a crisis (for instance, the inclusion of low-rated Portuguese or Slovakian guarantees to assist another eurozone member impairs the overall rating of the SPV to below AAA). For details, see “Terms of reference of the Eurogroup: European Financial Stability Facility,” Luxembourg, June 7, 2010, available at <http://tvnewsroom.consilium.europa.eu>. Despite its Luxembourg incorporation, the German Finance Agency will be responsible for German government debt sales, which will separately sell debt on behalf of the EFSF. See Brian Parkin, “German Finance Agency to Sell Bonds for Euro Fund,” Bloomberg.com, June 8, 2010, available at www.bloomberg.com.

21. Qualitatively, the Italian austerity program is less impressive than other

European crisis austerity packages with up to 40 percent of the fiscal impact coming from new revenues, most of which are from the dubious category of “fighting tax evasion.” See Boeri and Bordignon (2010) for a detailed description of the Italian program.

22. See Jacob F. Kirkegaard, “Austerity Proves Popular Among European Voters,” RealTime Economic Issues Watch, June 10, 2010, available at www.pii.com/realtime.

23. See Valentina Pop, “Germany sets EU example with €80bn austerity package,” euobserver.com, June 8, 2010, available at <http://euobserver.com>.

24. FT Markets Data: Bonds and Rates Overview, June 9, 2010, available at

to also be applied to most private creditors in the country in question in the form of higher costs of capital, put private business in, for instance, France in an unacceptable competitive position in the long run versus German competitors inside the EU Internal Market.

In the eurozone, where sovereign default premia are rapidly applied to fiscally weaker members, the ability of a German fiscal policy focused on austerity to forcefully dictate similar fiscal policies in other member states, including France, via financial-market pressure has grown dramatically. As such, the German domestic Constitutional Clause²⁵ for a balanced

Destroying the eurozone would... destroy the German banking system....

budget will prove to have strong future “extraterritorial implications” outside Germany within the eurozone.

The fact that the ECB have gotten such unprecedented policy initiatives “in return” from member states to its novel actions in the immediate aftermath of the grand bargain should further address concerns about the credibility of the ECB on price stability. At a time when European governments are legislating wage reductions and finally aggressively addressing their fiscal deficits and increasingly their structural growth barriers, too, worrying about inflation makes little sense.

So the question now becomes whether this new political commitment to a “new Stability and Growth Pact (SGP)” in whatever shape or form it will ultimately take will be any more credible than it was in 1997 (when the 60 percent debt stock criteria was abandoned) or in 2004 (when the big eurozone countries France and Germany undermined the 3 percent deficit criteria)? It’s early days, but the signs from Madrid and elsewhere so far are good. A probable future Greek default will furthermore illustrate to anyone in Europe just what the horrible result of noncompliance will be; the political cost of running unsustainable fiscal policies will rise—both at the eurozone level and domestically. Seeing what will happen to fiscally wayward countries is certain to shock European electorates and fundamentally alter what kind of fiscal policies are politically feasible in Europe.

<http://markets.ft.com/markets/bonds.asp>.

25. In 2009 Germany changed Article 115, II, in the German Constitution concerning government finances to include the clause: “Revenue and expenditure are principally to be balanced without revenues from credits. This principle is satisfied if revenues from credits do not exceed 0.35 percent in relation to the nominal gross domestic product.” The federal government is exempt from this clause until December 31, 2015, while German state governments are exempt until December 31, 2019. Text from German Constitution, available at www.servat.unibe.ch/icl/gm00000_.html.

Moreover, now that the days of phony eurozone government bond yield convergence are gone for good and financial markets happily and rapidly apply very significant default premia on irresponsible eurozone countries, the “new SGP” will get a real time financial-market enforcer that the old one never had. The “new SGP” will not have to just rely on the failed “EU political peer pressure” that undermined the prospects of the original.

Put another way, the European house will remain “half-built,” but from the “grand bargain” the world gets to find out whether this is a fundamentally flawed design and whether all the “optimal currency area” advocates are right or not, or if Europe’s experiment with monetary union without political union merely requires that countries actually stick to the rules.

Some might argue that suddenly relying on global financial markets to enforce Europe’s commitment to future austerity is akin to relying on a manic-depressive policeman demanding too much austerity one day, only to look the other way the next. That risk certainly exists. However, given the already high levels of public debt in many eurozone countries, the continent’s low potential growth rate and accelerating

The economic, as well as the political, case for a German departure from the eurozone is nonexistent.

demographic decline in particularly the Eastern and Southern parts, it seems highly unlikely that anything other than decisive government austerity measures to address Europe’s public debt problems will cause bond market vigilantes to turn their attention elsewhere.

Moreover, the significant risk for junior private bondholders that very sizable haircuts will be imposed on them in any future Greek debt default/restructuring could further sharpen financial markets’ intention to enforce future government debt sustainability in Europe. As such, ironically, a possible Greek debt default might significantly aid the long-term success of Europe’s austerity-driven “fiscal straitjacket.” Apart from imposing severe losses on junior private Greek debt holders, such an event would further reduce future risks of moral hazard in the eurozone by illustrating the European Union’s willingness to “let insolvent countries go,” while acting to protect only the general European interest and solvent members from the associated contagion.

Lastly, it would be a mistake at this early stage to rule out the possibility that on-going EU efforts led by EU Council President Herman van Rompuy to reform the SGP—clearly

headed toward significantly more forceful political implementation of the SGP with potentially automatic sanctions against fiscally wayward countries—will produce a political institution far more credible than its failed predecessor. In such a scenario, the SGP would go from not being enforced during its first decade either politically by the EU leaders or economically by financial markets to suddenly being enforced by both.

BETTER FEARED THAN LOVED IS TRUE FOR CURRENCY UNIONS, TOO

After the May 2010 grand bargain, the eurozone will consequently remain without a central transfer mechanism to overcome future geographically concentrated “asymmetric shocks.” Combined with continuing low levels of actual labor mobility across member state borders (or often even within them), the European institutional framework will therefore for the foreseeable future remain at odds with several of the theoretically identified basic tenets of an optimal currency area (OCA).²⁶

However, while the OCA theory has without a doubt been useful in identifying the weaknesses in the existing eurozone institutional framework until now, and as such can be said to have predicted the euro’s current difficulties, it is worth remembering that OCA theory predicted in the first place that the euro would never happen. Correspondingly, it is not surprising that OCA-based predictions today still suggest that the euro is bound to fail. Such predictions, though, should be dismissed, especially those premised on the lack of a Keynesian “central transfer mechanism” in the eurozone.

Instead, as discussed above, from now on Europe will hold its currency union together through a “fiscal straitjacket” and the willingness to endure difficult economic times to avoid another Greek scenario. In that sense, Europeans watching Greece, similar to Brazilians watching Argentina’s fate after 2001, will now be willing to accept tight fiscal policies and hitherto unacceptable social reforms. While this type of structural reforms, like labor market and pension reforms in Spain or increases in retirement age in France and elsewhere, will lead to some improvement in the potential growth rate in the long term, the eurozone will remain far from an OCA as it is defined by economic theory, and membership will be associated with significant costs for particularly Southern peripheral countries.

Continuously at risk of asymmetric economic shocks, but without the monetary policy tool and from now on largely without fiscal policy, too, peripheral eurozone members whose business cycles are not closely aligned with those of the large

core member states will have to “overinsure” against the asymmetry of euro membership through exceptionally sustainable fiscal policies and flexible, innovation-oriented, procompetitive social models. In short, all peripheral eurozone members will now have to become a lot more like, say, Finland.

However, there is no chance that the eurozone will break up as a result of the current economic crisis and in the long term from the effects of the grand bargain. First of all, leaving the euro will come at catastrophic cost to any nation that tries to do so out of economic weakness. Even eurozone countries that go into default will be far better off doing so inside the eurozone than outside (crucially eurozone members cannot be kicked out), as they will still have access to the deep liquid eurozone financial markets in the long term. Any euro-denominated interest rate imposed by financial markets even after a default will be a lot lower than interest rates on “new drachma denominated bonds.”²⁷

Moreover, a unilateral desire to leave the eurozone under the existing Lisbon Treaty would require that a eurozone member to quit the European Union entirely. This would entail near complete regional political isolation for the country in question, and in all probability it will also be suddenly subject to the European Union’s external trade barriers.

Further, it is important to note that ditching a physical currency that remains the legal tender in other countries is very different from simply breaking a currency peg, as Argentina did in 2001. As the introduction of euro notes and coins showed in 2002, a new physical currency involves a drawn-out, month-long logistical operation in order to empty and refill all automated teller machines, etc., which cannot be kept secret from the public. During this period, any country wishing to leave the euro and reintroduce a new weaker national currency would experience a devastating capital flight, as private residents would rush to transfer their money out of the country prior to the switch to a new weaker currency.²⁸

While the argument can be made that quitting the euro after a sovereign default has already caused the almost inevitable collapse of the domestic banking system would not add much to the already existing economic chaos and hence would be potentially possible,²⁹ this view ignores several important issues. First, there is a lot more to an economy than the banking system, and leaving the euro for a weaker currency would essentially cast all private contracts originally denominated in

26. See Mundell (1961) for the original description of the optimal currency area theory.

27. See also Buiter (2010) for an in-depth discussion of the preference for a Greek default within the eurozone.

28. See Eichengreen (2007) for the original formulation of this argument.

29. See, for instance, Paul Krugman, “How Reversible Is the Euro?” *The Conscience of a Liberal*, April 28, 2010, available at <http://krugman.blogs.nytimes.com>.

euros into default or face rapidly rising liabilities through a depreciating “new drachma.” Second, countries that seek to reintroduce a new national currency must have reasonable expectations of large export gains from a competitive devaluation. However, in the case of Greece (and essentially all of the Mediterranean eurozone members, with Italy as the partial exception), large export gains from even a large competitive devaluation look very unlikely.

As I described in a recent PIIE RealTime piece, with a total “goods export intensity” of just 7 percent of GDP in 2008, Greece is by far the least goods export oriented country in the eurozone.³⁰ The country fundamentally makes very little that the rest of the world wants to benefit much from the short-term pricing advantages of reintroducing its own currency.

While the eurozone won't break under the strain of the current crisis, it will nonetheless be a very different eurozone after the grand bargain, especially in its Southern part.

Moreover, Greece's two large services sectors—tourism and shipping—are highly sensitive to social unrest (guaranteed with the introduction of a new drachma) and conducted almost wholly in US dollars for both revenues and costs. These sectors also are unlikely to benefit much from a competitive Greek devaluation. The economic gains for Greece associated with leaving the eurozone thus are like the Sirens—seductive but mythical.

Similar misconceptions exist about the willingness and possibility of the eurozone anchor country, Germany, leaving the eurozone. It is politically unthinkable that Germany would undermine 60 years of pro-European policies by leaving the eurozone and thereby destroy the entire European Union, which has anchored its identity and powered its post-war authority. Recall that the German parliament drew broad political support for the recent €750 billion EFSF from both the governing CDU-FDP coalition and the main opposition parties SPD/Green Party. That backing came despite the potential price tag of more than €150 billion for Germany. The SPD/Green Party abstained in the vote only because of

opposition to the lack of private-sector involvement (i.e., pain for the banks) in the package.³¹ In other words, only a Germany ruled solely by the far left party, Die Linke, which received just 11.9 percent of the vote in the 2009 German national elections, would conceivably oppose current policies.

This broad political support among the German political parties matters. German politicians are elected by proportional representation, a system that awards power to smaller and bigger political parties. Financial markets fearing a departure from the eurozone by Germany, where the euro is admittedly more and more unpopular, still attach far too much importance to single-issue polls on this issue.

The experience of European countries³² that have undergone popular referenda on EU-related issues is that whereas voters reject the recommendations of their elected politicians on such matters, there is next to no impact on how they vote in the next general election. There is no reason to believe that the German electorate is different. Polls showing public dissatisfaction with the euro will not likely lead to a massive swing of voters to Die Linke or a new “anti-EU protest party” in the next German election. The polls can therefore be largely ignored.

There is a striking contrast between the power of populist fringe groups in the United States and Europe. Many American commentators accustomed to the ability of populist groups to win in closed winner-take-all primaries—as the Tea Party candidates have done this year—underestimate the stabilizing political effect of proportional representation in Europe. Commentators also underestimate the electorate's and the government's deeply institutionalized attachment to the European Union, which will make it harder to attract the popular majority required in proportional representation systems in support of an EU pullout. In essence, Europe's political systems today are far more elitist than that of the United States, which is crucial when thinking about the risk of populist policies actually being implemented.

Moreover, as has forcefully been argued by Adam Posen recently, Germany retains huge economic advantages from being in the eurozone in the form of seigniorage, deeper bond markets, and the inability of close trading partners to devalue.³³ Add hereto the €972 billion (data from end 2010Q1) in German bank exposure to other eurozone countries, of which €355 billion pertains to Greece, Italy, Spain, and Portugal, as of end-March 2010.³⁴ All of these claims would be severely

30. Jacob F. Kirkegaard, “The Role of External Demand in the Eurozone,” RealTime Economics Issues, May 27, 2010, available at www.piie.com. Greece exported for more than €500 million in just four HS six-digit categories in 2008; light petroleum distillates (HS271019), bulk medical supplies (HS300490), fresh fish (HS030269), and “other” (HS999999). Data are from UN Comtrade Database, available at <http://comtrade.un.org>.

31. See “Merkel Pushes Euro Rescue Deal Through Parliament,” Spiegel Online International, May 21, 2010, available at www.spiegel.de.

32. Denmark, Sweden, Ireland, France, and the Netherlands.

33. Adam Posen, “Having a Large Euro Area Is an Advantage for Germany,” op-ed in Die Welt, February 19, 2010, available at www.piie.com.

34. Data are from the Deutsche Bundesbank, available at www.bundesbank.de.

impaired, were the other eurozone countries to reintroduce their own weaker currencies, adding intolerable strain to an already weak German banking system. Destroying the eurozone would therefore destroy the German banking system far more completely than any Greek default could achieve. In summary, the economic, as well as the political, case for a German departure from the eurozone is nonexistent.

Yet, while the eurozone won't break under the strain of the current crisis, it will nonetheless be a very different eurozone after the grand bargain, especially in its Southern part. Originally designed as the ultimate symbol of European monetary integration and the firm foundation of rapid economic growth in the Southern peripheral members that would deliver convergence in living standards with the richer Northern parts of Europe, from now on the euro will have no such positive vision associated with it. Rather than economic

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growth and rising living standards, the euro will now extend a damp deflationary—potentially even Thatcherite—embrace to its Mediterranean members, forcing their leaders to legislate lower public wages and overhaul their social and economic models to avoid the catastrophic Greek-like debt spiral. But as mentioned above, the eurozone will hold together, though no longer by a positive vision of the common future but by the realization of the staggering cost of leaving.

As Machiavelli wrote on whether it is better for a ruler to be loved than feared:

“It may be answered that it...is much safer to be feared than loved... because friendships that are obtained by payments...are not secured, and in time of need cannot be relied upon;... but fear preserves you by a dread of punishment which never fails.”³⁵

As with princes, so too with currency unions made up of democratic nations. It will prove far safer to have the euro held together by elected governments fearful of the cost of leaving and consequently willing to do whatever it takes to avoid this outcome than relying on excessively low cost of capital from a spurious convergence of government bond yields upon entry

to produce unsustainable short-term bursts of growth in the periphery. This is true for weaker eurozone states, as well as for Germany, which has proven willing to shoulder much of the economic burden of this crisis solution once again. The euro is therefore safer today than ever, and the only change in the eurozone will come through expansion, starting with Estonia in 2011.³⁶

WHAT MORE IS NEEDED FOR THE EUROZONE

The Troubled Asset Relief Program (TARP), associated bank stress-tests, and not least the Fall 2008 US political crisis management process that led to these initiatives being first rejected before they were ultimately passed by the US House of Representatives were widely ridiculed at the time. Today, however, most observers would probably agree that that these measures ultimately played a large and constructive role in containing the immediate financial-market crisis contagion in the aftermath of the collapse of Lehman Brothers. In time, Europe's grand bargain on May 9–10, 2010 to the Greek crisis will come to be viewed in a similar positive light.

The negative short-term effects on European economic growth of the grand bargain and the associated spillover into the European private sector from new public austerity measures are obvious, and despite the positive long-term impact of these policies, much still remains to be done for Europe's policy-makers to ensure that they do not let the current crisis go to waste. At least three issues stand out.

First, European governments must immediately begin to address the uncertainties surrounding capital adequacy of the eurozone banking system.³⁷ Despite the ECB recently estimating a potential €195 billion in eurozone banks' loan writedowns during the 18 months from June 2010 to December 2011 (ECB 2010, box 11), these estimates do not include any assumptions regarding the potential costs of a probable Greek sovereign default, which will with certainty be severe for junior private creditors (Mussa 2010). More action is urgently needed.

Transparent stress-tests of all large and complex banking groups in the eurozone must therefore, in a manner not dissimilar to the US process in early 2009, be conducted immediately by national eurozone regulatory authorities to identify the weakest links. Aggressive campaigns to raise additional private capital (diluting existing shareholders) must be encouraged, and

35. Niccolò Machiavelli, “Chapter XVII: Concerning Cruelty and Clemency, and Whether It Is Better to Be Loved than Feared,” in *The Prince*, written c. 1505, published 1515.

36. See European Commission (2010a) for its recommendation for Estonian euro membership starting in 2011.

37. For a forceful articulation of this important point, see Nicolas Veron, “EU Inaction Over Banks Grow Ever Costlier,” RealTime Economic Issues Watch, May 18, 2010, available at www.piie.com/realtime.

national eurozone governments must be willing, *ultima ratio*, to recapitalize severely stricken banks where additional private capital is unavailable in return for ownership status.

Without sound private banking systems, even the most sound government finances will not provide any benefits to general economic growth and indeed leave Europe at risk of suffering the fate of Japan's lost decade (the decade from economic crisis in the early 1990s until Heizo Takenaka's cleanup of Japanese banks after 2002). As such, governments in Germany and elsewhere in the eurozone bent on restoring overall fiscal austerity must expeditiously spend the required government resources to ensure that the eurozone banking system is sound and well capitalized.

A likely last integral part of "stress-testing" of the eurozone banking system will be to work out a negotiated process through which Greece can default on its debts with minimal

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risk of serious contagion effects. Here the role of the ECB, which will by now have a substantial exposure to Greek government debt through its collateral program and the new SMP, will be critical.³⁸

Second, implementation is what matters now. It is crucial that eurozone governments, particularly among the Southern members, deliver expeditiously on the austerity and not least structural reform commitments recently made. Spain, Portugal, and to a lesser extent Italy must now clearly draw a line between themselves and Greece in terms of both their fiscal sustainability and growth prospects. Particularly the latter will require additional pro-growth structural reforms.

However, as the entire eurozone will be putting on its new "fiscal straitjacket" and therefore—in addition to its previous loss of an independent monetary policy—will face severely restricted future fiscal policy room for maneuver, the entire eurozone must double efforts towards raising potential growth rates through structural reforms. National foci will vary among

individual member states—labor markets and pension systems in Spain, consolidation of regional Landesbanken and reform of the entire education system and services sectors in Germany, and pension system reforms in France—while at the EU level, completion of the Internal Market in Services is priority.

Third and only for the long term, the eurozone should consider introducing a potential "carrot" for members that successfully manage to put their government finances on a sustainable path. This carrot could come in the form of a future common "Maastricht bond," similar to the often suggested "eurobond," but open only to eurozone member states that actually adhere to the Maastricht Treaty debt stock criteria of a maximum level of government debt of 60 percent over an entire business cycle. A Maastricht bond would furthermore have "living will provision," enabling the expeditious expulsion from any Maastricht bond of countries that during the duration of the bond fail to adhere to the debt and other eligibility criteria.

Evidently, such a future Maastricht bond would in all likelihood be possible only with the participation of Germany and a critical number of eurozone members (French participation would not be strictly required, although preferable) as launching participants. Moreover, a Maastricht bond would through the opportunity to lock in lower interest rates from deeper and more liquid bond markets offer a powerful incentive for other eurozone countries to come into and remain in compliance with the Maastricht Treaty debt criteria. As such, a Maastricht bond would work toward the same goal as the EU Commission's recent proposals to reform the SGP³⁹ and go a long way toward avoiding the moral hazard concerns that have traditionally politically blocked the introduction of eurobonds, particularly in Germany. With only eurozone members that have roughly comparable government finances and adhere to the Maastricht debt stock criteria eligible, any deterioration in the national lending conditions of, for instance, Germany from participating in a joint Maastricht bond with other eligible countries would be very small. Including only roughly comparable countries in the joint Maastricht bond therefore greatly reduces the risk of moral hazard among the participating countries.

From a global perspective, successful introduction of a pan-European Maastricht bond by the end of the decade, at a time when the US federal government debt on current "business as usual" projections will be well above 100 percent of US GDP, could have serious implications for the future "global safe-haven" asset. At that point in time, a successfully launched pan-European Maastricht Bond, backed by the credibility of years of painfully endured austerity measures across a sufficient number of participating member states, could achieve a scale and market

38. For more details on the ECB's role in this process, see Jacob F. Kirkegaard, "The European Central Bank Calms the Storm—for Now," RealTime Economic Issues Watch, May 4, 2010, available at www.piie.com/realtime and Jacob F. Kirkegaard, "The Biggest Losers: Who Gets Hurt from a Greek Default or Restructuring," RealTime Economic Issues Watch, April 27, 2010, available at www.piie.com/realtime.

39. See EU Commission (2010b, 5) for the suggestion that "the debt criterion [60%] of the excessive deficit procedure should effectively be implemented."

depth not far off today's US treasury market. A European Maas-tricht bond could consequently pose the first serious threat to an increasingly fragile US treasury market as the "global safe haven" asset—a threat that if deemed credible might again prove to be the final push for the US Congress to get serious about dealing with the long-term US debt sustainability concerns.

Ironically, European austerity measures would then have been what ultimately politically enabled new US federal government revenue increases.

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